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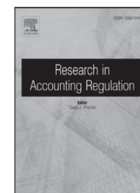

Regular Paper

Value relevance of customer-related intangible assets

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ABSTRACT

This study examines the stock market's valuation of customer-related intangible assets for a sample of publicly-traded U.S. firms. Customer-related intangible assets are found to be positively associated with equity prices, but valued at a discount relative to goodwill. These results suggest that value-relevant information is lost if customer-related intangible assets are subsumed into goodwill rather than being reported separately. This evidence can be useful to standard setters potentially considering extending to public companies a recent FASB Accounting Standards Update allowing private companies not to recognize separately from goodwill certain customer-related intangible assets.

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1. Introduction

Business combinations employ fair value accounting. Acquiring companies recognize the assets acquired (and liabilities assumed), including identifiable intangible assets, at their estimated fair values. Goodwill is then the residual of fair value of consideration given less the fair value of identifiable net assets acquired. Measuring the fair values of identifiable intangible assets is often challenging. For example, fair values and intangible assets are listed in the top ten topics appearing in a recent study of SEC comment letters (Deloitte, 2017). Similarly, PCAOB inspections reveal "accounting estimates, including fair value measurements" as one of the most frequent sources of recurring audit deficiencies (PCAOB, 2017). Consistent with difficulty in measuring the fair values of acquired identifiable intangibles, goodwill is typically a large portion of the assets acquired in business combinations (Shalev, Zhang, & Zhang, 2013; Houlihan Lokey, 2016).

A large body of research has examined goodwill (Wen & Moehrle, 2016) and intangible assets (Wyatt, 2008). For example, evidence suggests equity values are positively related to recorded goodwill (e.g., Jennings, Robinson, Thompson, & Duvall, 1996), in-process research and development projects (Deng & Lev, 2006), and recognized software development cost assets (Aboody & Lev, 1998). Extant research however has left relatively unexamined the value relevance of separately identified intangible assets acquired in business combinations. The purpose of this paper is to examine the value relevance of one such intangible, customer-related intangible assets.

The issue of equity investors' valuation of customer-related intangible assets is important for two primary reasons. First, in the U.S., annual investments in intangible assets are estimated at roughly 10% of GDP (Nakamura, 2008). Customer-related intangible assets, such as data on customer preferences and buying patterns, are a significant part of this investment. In recent samples of acquisitions, 69% of acquirers allocated some portion of the consideration given to customer-related intangible assets (Houlihan Lokey, 2015 and 2016). Further, allocation to customer-related intangibles is prevalent across industries, and comprises about 20% (mean) of the fair value of consideration given (Houlihan Lokey, 2015).

Second, Accounting Standards Update (ASU) 2014–18 *Business Combinations (Topic 805), Accounting for Identifiable Intangible Assets in a Business Combination*, allows *private* companies to elect not to recognize separately from goodwill certain customer-related intangible assets (FASB, 2014b). The FASB asserts that this new guidance "will continue to provide decision-useful information to the users of private company financial statements while providing a reduction in the cost and complexity associated with the measurement of certain identifiable intangible assets" (FASB, 2014b). Not all agree with this decision. Some users of private company financial statements indicate they consider the fair values of specific intangible assets to be relevant in some decisions. The dissenting FASB members in the 4-3 ASU 2014–18 decision cite a lack of evidence that customer-related intangible assets are less relevant than other intangibles recognized under current standards. In addition, dissenters assert that measurement costs may be even greater for public entities due to scrutiny by regulators and public

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accountants. Finally, Ernst and Young, in its exposure draft comment letter, states:

> "…we believe that recognizing intangible assets at their estimated fair values is a more faithful representation than would be provided if those intangible assets were subsumed into goodwill. We therefore do not understand how including such assets in goodwill would facilitate analysis of financial statements aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows" (EY, 2013).

This paper's purpose is to examine equity investors' valuation of customer-related intangible assets for a sample of publicly-traded U.S. firms.[1] Two research questions are addressed. First, are customer-related intangible assets recognized in business combinations relevant to equity investors? Second, if so, do equity investors price customer-related intangible assets and goodwill differently? Empirical evidence on these research questions can help assess whether value-relevant information is lost if customer-related intangible assets are subsumed into goodwill.

The empirical tests require hand-collected financial statement data. Beginning with a sample of firms with significant intangible assets in total per Compustat, the EDGAR database was electronically searched for key terms related to customer-related intangible assets.[2] The financial statement footnotes for these firms were reviewed, resulting in a sample of 1698 firm-year observations (303 distinct firms) over 2010–2015. Multivariate regressions were estimated, based on modifications of the theoretical model of Feltham and Ohlson (1995).

Two key findings emerge. First, equity values are positively related to the book values of customer-related intangible assets, after controlling for the other determinants of equity values, including goodwill. Second, equity investors value customer-related intangible assets *less* than they do goodwill. This set of results together suggests equity market investors value customer-related intangible assets and would experience a loss of value-relevant information if such assets were instead subsumed in goodwill.

This study provides three key contributions. First, no prior empirical evidence on the value relevance of customer-related intangible assets appears to exist. This paper adds to a long line of value relevance literature (Barth, Beaver, & Landsman, 2001). Second, the study contributes to research which generally documents equity valuation benefits of disaggregated accounting information, including earnings and book values (Ohlson & Penman, 1992), periodic pension cost components (Barth, Beaver, & Landsman, 1992), and deferred tax assets and liabilities (Bauman & Shaw, 2016; Legoria & Sellers, 2005). Third, this study adds to research on private company accounting and standard setting, some of which is summarized in Habib, Ranasinghe, and Huang (2018).

The main takeaway from this study is that subsuming customer-related intangible assets in goodwill would create a loss of value-relevant information for equity investors. This comports with related research that documents negative consequences from extant business combination accounting. For example, Shalev et al. (2013) find that CEOs compensated more with earnings-based bonuses allocate relatively more of the fair value in acquisitions to goodwill, arguably to increase the amounts of their future bonus pay. Li and Sloan (2017) document inflated goodwill balances and untimely recognition of goodwill impairment losses. Further, Li and Sloan (2017) find that equity investors do not anticipate the untimely nature of goodwill impairments, thus resulting in temporarily inflated equity prices. This study's findings, in conjunction with prior research, suggest standard setters should not extend the elections allowed in ASU 2014–18 to public companies.

The paper proceeds as follows. The next section discusses institutional background and develops research questions. The third section discusses empirical methods. The fourth section discusses sample selection, describes the data, and presents results. Section five discusses regulatory issues and section six concludes.

2. Background

2.1. Accounting issues

Under Accounting Series Codification (ASC) Topic 805, *Business Combinations*, an acquirer must recognize at their respective fair values those assets acquired and liabilities assumed in a business combination. This includes any identifiable intangible assets, i.e., previously unrecognized intangibles that arise from contractual or other legal rights or are separable.[3] Goodwill is recorded only after all acquired tangible net assets and identifiable intangible assets are recognized.

The Codification identifies five broad groups of identifiable intangible assets, including customer-related intangibles.[4] Four categories of customer-related intangibles are identified in ASC 805-20-55-20 to 28.

- *Customer lists* consist of specific information about customers, such as names, order histories, and demographic data. As customer lists are often leased or exchanged, they meet the separability criterion as an identifiable intangible.
- *Order or production backlogs* arise from purchase or sale orders, thereby meeting the contractual-legal criterion.
- *Customer contracts and the related customer relationships* are also identifiable under the contractual-legal criterion.
- *Non-contractual customer relationships* acquired in a business combination may be identifiable if the relationship is separable. An example cited in the Codification is relationships with depositors, which are often exchanged with the related deposits.

2.2. The Private Company Council

The Private Company Council (PCC) advises the FASB on (1) the appropriate accounting treatment for private companies for items under consideration on the FASB's agenda and (2) possible alternatives within GAAP to address the needs of users of private company financial statements (O'Dell, 2015). For projects on the FASB's technical agenda, the PCC advises the FASB on potential implications for private companies. For proposed alternatives to GAAP, those approved by the PCC are submitted to the FASB for a decision on endorsement. As described at FASB.org, the PCC and FASB work closely together, and FASB members are expected to attend PCC meetings.[5]

2.3. Recent regulatory actions

In February 2013 the PCC added to its agenda the accounting for identifiable intangible assets acquired in a business combination. This was done in response to stakeholder concerns that the

[1] Data limitations preclude the inclusion of private companies in the sample. However, dissenters to the FASB decision suggest extending the election allowed in ASU 2014–18 to public companies, and FASB outreach "provided no evidence of differences in the relevance of identifiable intangible assets that are required to be recognized under current GAAP for users of private and public entity financial statements" (FASB, 2014b).

[2] The sample selection process is described more completely in Section 4.1.

[3] Per ASC Topic 805, an intangible asset is separable if it is "capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so".

[4] The other groups are contract-based, marketing-related, technology-based and artistic-related.

[5] See further detail at fasb.org/pcc/aboutus&pf=true.

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